THE STATE OF OUR NATIONAL FINANCES[1]

In considering the state of our finances, we must be continually mindful of the interaction between fiscal and financial affairs, that is, between public and private finance. The relation is reciprocal. Obviously, governmental finance is always profoundly affected by the general economic situation. Oscillations of the economic pendulum from good to bad times, from prosperity to adversity, inevitably exert an influence upon public revenues and budgetary conditions. Government revenues must always stand in a certain relation to the social income, and any expansion or curtailment of the latter is at once reflected in corresponding fluctuations of the former. There is also an intimate relation in the opposite sense. Just as economic theory, while at bottom an expression of the facts of the economic environment, often succeeds in setting in motion a train of thought which molds the attitude of men to economic phenomena and thus helps in a certain measure to alter them, so the fiscal activity of government may make or mar the canvas upon which the economic activity of the people puts the pigments and the broad touches of business life. While, then, we are to address ourselves primarily to the public phase of the subject, this mutual interrelation justifies dwelling, for a moment at least, upon the private phase.

In adverting, by way of introduction, to this aspect of the problem, we are struck by two commanding facts. The one is that we are living through a period of deflation, the other is our credit situation. A word as to each of these. One of the most hopeful signs on the horizon is the growing recognition by the community at large of the existence, so long familiar to the student, of the business cycle; of these alternate periods of vivid anticipations and shattered hopes that we associate with the crest and the trough of the billowy ocean of economic life. Whatever be the explanation of high wages and exaggerated profits as contrasted with the prevalent unemployment and business losses—whether or not we are to agree with Jevons of a former generation and with my valued colleague, Henry L. Moore, at present, in seeking the reason proximately in variations of agricultural production or more fundamentally in meteorological and astronomical facts—it remains none the less true that since these dynamic changes reflect themselves in social conditions, they are susceptible, within a certain measure at least, of social control. Civilization itself consists of the successful endeavor to enchain the forces of nature: within broad, even though obvious, limits progress results from control

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and intelligent guidance of natural forces. The most encouraging aspect of the President's Conference on Unemployment was a recognition of the fact that there is here a problem worthy of study and susceptible of possible solution in the future.

The gravity of our present economic situation is, however, accentuated by the fact that in addition to the cyclical movement we are living in the aftermath of the most gigantic world conflict ever known. To put a familiar situation in economic terms, we may say that the recent conflict marks for the first time in history the application to war conditions of a situation hitherto familiar only in peace. The factory system, as a result of the industrial revolution, has for some decades dominated normal economic life: now for the first time the factory system has become a characteristic of the abnormal condition that we call war. The consequence has been that instead of the militia or mercenaries of former days, the entire nation has been drawn into the operations of war, either at the front or behind the lines at home. In the second place, the substitution of the unproductive consumption of war for the normal surplus of productive consumption in peace has proceeded at such a terrific pace as to trench seriously upon the social capital and the social income—to such an extent, even, as almost to imperil the structure of civilization. Putting it in financial terms, it has meant such an inflation and such a prodigious rise in the price level, with the familiar concomitants of irredeemable or inconvertible paper money, as even to transcend the ravages of the continental currency in the American Revolution and the effects of the assignats in France.

The evils of such a situation have been recently depicted in a passage which I venture to quote:

> The prosperity, we have said, is illusory. With the rapid rise of prices, those who have no commodities to dispose of suffer severely. The creditor is in an unhappy position and the recipients of fixed incomes are compelled to resort to all manner of unworthy expedients in order to make both ends meet. The continual fluctuations of price introduce an uncertainty in business which is only temporarily masked by the advance. The opportunities of a sellers' market irresistibly lead to profiteering and its attendant evils. The sudden increase of the paper income produces private extravagance and public prodigality. The exaggerated rise of wages, coupled with the unceasing demand for labor, engenders a demoralization which soon returns to plague the industry. The habits of thrift, painfully built up during a lifetime, are abruptly discarded. The kaleidoscopic mutations of paper fortunes, amassed almost over night, beget a spirit of speculation and of peculation. The feverish activity of the market destroys the habits of orderliness and sobriety, and the brilliant prospects of suddenly acquired wealth create in the public a delirium of improvidence and the sense of living in a veritable golden age.

The day of reckoning, however, soon follows. When the wave rises to a crest, it breaks with an overwhelming force; when the fever subsides, the resulting weakness is intense. As the paper finally loses its value, fortunes are now suddenly wiped out, and many of the supposedly wealthy find themselves beggared. With the collapse of demand, unsalable stocks deplete the business inventory and failures are the order of the day. Those who have habituated themselves to an extravagant mode of life are faced with the grim necessity of immediate retrenchment. The laborer resists to the uttermost any lowering of his wages, however necessary it may be to the reëstablishment of the new equilibrium. The government finds itself embarrassed by the drying up of the sources of its revenue. The prudent and the patriotic, who have undergone sacrifices in order to invest in government paper, suffer for their patriotism. The splendors of the former prospects are now seen to have been only a mirage. The golden age of inflation turns out to have been after all nothing but a gilt-paper age.[2]

That we have been in a measure exempt from these deplorable consequences is due in part to the fact that we were so late in joining the fray. Toward the end of the conflict, however, our expenditures were so much greater than those of any other belligerent that even a short continuance of the war would have brought us, like our Allies, to the very brink of ruin.

The second favorable factor in the situation consists of the conditions of credit to which reference has been made above. When the economic history of the Great War comes to be written, it will be realized that we were saved primarily by two fortuitous occurrences. The one was the passage of the sixteenth amendment without which we should have been unable adequately to tap the abundant streams of social income. The second was the enactment of the Federal Reserve law which enabled us to utilize new and most elastic possibilities of a gigantic expansion of credit with only a moderate degree of inflation and without recourse, as in every other country, to what was virtually fiat money. Our escape is due in large measure to the farsightedness of Mr. Paul M. Warburg, whose brain first conceived, and whose untiring efforts helped to achieve, the system upon which our modern credit life rests. To the student of financial science, the name of Warburg will be linked with that of Lord Overstone in the annals of banking reform.

But while so much was accomplished during the war by the existence of a combined or united reserve, the recent experience of both inflation and deflation discloses the desirability of a second reform in our system, almost as imperative as the first. Most of the attentive students of the problem have been aware of the fact that perhaps the most im-

[2]Edwin R. A. Seligman, *Currency Inflation and Public Debts* (New York, 1921), pp. 59-60.

portant contributing element in the upward speculative movement of a boom period is not alone the assistance, but the additional impulse, coming from the banks. While no one can read the illuminating testimony of Governor Strong of the Federal Reserve Bank of New York, before the recent Joint Commission of Agricultural Inquiry, without realizing the remarkable accomplishments of that particular institution, it remains none the less true that under actual conditions our banks as a whole often expand credit when they ought to restrict, and restrict credit when they ought to expand. The reason for this credit inflation when nearing the crest of a boom period is to be sought largely in a continuance of the competitive conditions among our thirty thousand American banks. What we need more than anything else in this country at present is a campaign of education designed to familiarize the public with the desirability of branch banking, whereby the multiplicity of competitive institutions may be converted into a chain of coöperative banks working together rather than at cross-purposes, and affording the business community equal facilities in normal times and a greater protection in abnormal times. Despite the deep-seated feeling of opposition to branch banking which is still mistakenly entertained by our local financiers, I venture to affirm that the substitution of coöperation for exaggerated competition in credit is second in importance only to the substitution of united for scattered reserves that has been brought about by the federal reserve system.

II

In considering the present situation of our public finances, we cannot avert a glance from the immediate past. While the war finance policy of the United States has naturally engendered not a little criticism, and has in turn evoked a defense on the part of our former government officials, it may be said that on the whole we passed through those trying years with a minimum of avoidable discomfort and with a record of official intelligence and foresight which is in marked contrast to the ineptitude of the programs of our previous war periods, such as the War of 1812 and the Civil War. There are only two points—albeit important ones—in which serious errors were committed; and we can defend ourselves against the charge of hindsight, rather than foresight, because in both these respects we had the privilege of warning the Secretary of the Treasury and the Senate Finance Committee at the time.

The first point was the refusal of the government to listen to any suggestion to pay the market rate of interest on the government loans, as was done abroad. The natural result was not only to affix to the

loans the character, in part at least, of a compulsory contribution, but—what is much more serious—to depend so largely upon the banks, as well as upon the issue of the temporary loan certificates, as seriously to accentuate the evils of inflation. The second point was to rely to such an exaggerated extent upon taxes on wealth rather than in part upon taxes on consumption, as to incur two evils. One of these was the failure to bring about an adequate restriction of social consumption—a failure which, had the war continued, would have inevitably meant the adoption of the rationing system. The other error, of a double character, was in connection with the income and profits taxes. In the income tax there was fastened upon us the policy of tax exemption which is returning to plague us at present. And, on the other hand, the excess-profits tax, however defensible in principle as a method of tapping war gains, was so arranged as not only to create the greatest inequalities at the very beginning, but to prove an unendurable burden as soon as the war was over. These points were fully explained in the report of the war finance committee of this Association, of which I had the honor to be chairman; and they had already been intimated, long before that report, to the responsible authors of our war finance policy. Our skirts, at least, are clear.

What we are concerned with, however, is not so much the past as the present and the future. From this point of view, let us consider first the expenditure side of our balance sheet, present and prospective, and then the revenue side. The first point on the expenditure side is the evident necessity of cutting down the total outlay of the government. When expenditures rise from a pre-war level of about one billion to a post-war level of over four billions, the need of retrenchment, even after making allowance for the change in the value of money, is self-evident. Two plans have indeed recently been suggested which will in some degree remedy the situation: the one is the proposed reduction in our naval armament, the other is the adoption of the new budgetary system. But even these are by no means adequate; they must be followed by other measures which will secure economy without sacrificing efficiency.

Of these problems, the most immediate, and by no means the least unimportant, is the debt problem. Here we are faced with the huge item of well over one and a quarter billion dollars for the annual contribution to interest charges and amortization. As to the interest charges, there can of course be no question. But the plan of a compulsory sinking fund, of such a magnitude as that upon which we have entered, is of more doubtful expediency. It goes without saying that the payment of a debt is on general principles highly desirable; and it is also true that the best time to start the payment of a war debt is during the

period of comparatively high prices, when the final deflation has not yet occurred. Where the public debts, however, aggregate such gigantic figures as at present, the ultimate question is always as to the comparative effects of the pressure of taxation required to meet these payments. Where, as at present, the burdens of an excessive war taxation are still so serious as to impair the replenishment and the increase of the social capital, the question arises whether it would not be desirable to introduce more elasticity into the process of debt payment. It is familiar that the compulsory sinking fund instituted in the Civil War was soon disregarded by the authorities and that the reduction of the debt proceeded on different principles, comparatively small amounts being paid while the pressure of taxation was great and correspondingly larger amounts—far more than was required by the compulsory sinking fund provision—when, despite the lighter pressure of taxation, the revenue became more abundant. In other words, a sound debt-payment policy will compare the advantages of a rapid diminution of the debt burden with the corresponding advantages of a rapid decrease of the tax burden, and with the possibility of adjusting the tax system to fundamental principles. We may indeed not be compelled to resort to the shifts to which Great Britain finds herself reduced this year—that of borrowing money in order to keep up the sinking fund—for there is scarcely anything more absurd than that; but we may see ourselves exposed to the hazard of retaining undesirable forms or rates of taxation in order to carry out the provisions of a law which ought not to have been put in so rigid a form. A successful debt-payment program should possess the quality of elasticity, rather than rigidity.

The second problem of immediate importance is that of the Allied indebtedness. Perhaps in no part of the entire subject is there more need of clear thinking and of public enlightenment. This is true on both the ethical and the economic phases of the subject. I have little patience with those— undoubtedly still a majority in this country— who consider it a just debt. For, after all, what is the real situation?

There is indeed much to be said for the plan followed, both by Great Britain and by ourselves, in putting our assistance to the Allies in the form of loans rather than of gratuities. For the plan of making free gifts to the Allies, permitting them to spend the funds as they liked, would have involved a serious risk of extravagance and waste, as exemplified in the scandals of the Russo-Japanese War. A loan, on the other hand, would not only permit of more control on the part of the lender, but would superinduce more care on the part of the borrower. We are always more careful in spending our own money than

that of some one else. The policy of loans rather than gifts undoubtedly contributed to a more effective prosecution of the war.

Much the same may be said of the second element in the inter-Allied financial policy of the war—the principle, namely, that each nation should be charged with the expenses incurred in behalf of its own citizens, no matter when or where incurred. In virtue of this principle, we paid Great Britain for the transport of our troops and reimbursed France for the cost of the 75's which were so desperately needed by our troops. Any other plan would have led to confusion, to prodigality, and to interminable disputes. Only by making each nation responsible for the cost of its own forces could we have hoped to secure even a measurable degree of economy.

It can, however, not be too strongly emphasized that these were matters of expediency, calculated to achieve the greatest efficiency in the conduct of the war. From the point of view of justice, they cannot be defended for a moment. It is, in fact, exceedingly doubtful whether it was ever expected at the time that the loans would be repaid. At all events, this is true of the loans made by Great Britain to her Allies. If the war was a joint enterprise, carried on for a common purpose, there is as little reason to separate the financial contribution as the human contribution. When we finally put our army under the orders of Foch, we fused our efforts with those of our Allies and gave an indelible stamp to our common efforts. If we are to charge France and Italy for the wheat that kept their forces alive, for the uniforms that kept their soldiers warm, we might as well charge them so much per man of the American army. Do we desire to put ourselves on the level of the Hessian rulers who supplied Great Britain with the mercenaries during our Revolution?

What actually happened was that the Allies furnished a huge armed force which only with difficulty withstood the onset of the enemy. In this huge force the human element was represented primarily by France and Italy; the materials were furnished largely by Great Britain; and the food was contributed chiefly by the United States. All three elements were indispensable to the wininng of the war; the absence of any of them would have spelled disaster. The mere fact that our chief contribution was rendered in the shape of book credits must not be permitted to obscure the facts. As Mr. Trauton says in the article designed to show the impolicy of the attempt on the part of Great Britain to collect the debts owing to it by the Allies:[3] "Now that the conflict is over, one section of the group should not attempt to transfer part of the burden of the war already borne by it to another section which has already borne a greater burden. Those sections which

[3]*The Economic Journal*, March, 1921, p. 43.

have suffered least from the devastation and the loss of life entailed by the war should, if anything, bear a correspondingly greater proportion of the financial burden than that borne by those crippled by the loss of many lives. Yet, should payment of inter-Allied debts be exacted, the very reverse would be the case."

And, as he says in another passage: "It would be almost impossible to elaborate a scheme which would distribute the burden of the war equitably among the Allies. But undoubtedly the most unjust way imaginable would be for the present creditors to extort payment of their debts from the present debtors."

To this consideration, which applies to Great Britain as well as to ourselves—for Great Britain loaned to the Allies about as much as she borrowed from us—there is a further consideration which is peculiar to the United States.

It is true that we entered the contest with clean hands and with clean hearts: we poured out lavishly our treasures and the lives of our soldiers; we had nothing material to gain from victory; and we sedulously refrained from even advancing any claim to a division of the spoils. So far, so good. But consider the other side for a moment. How are we to explain the almost simultaneous appearance of war-profits taxes in every country if not on the ground of conviction that it is illicit for an individual to make profits out of the blood and misery of his fellow countrymen in so fearful a crisis. But if it is indefensible for a private individual to retain all, or even a large part of, such profits, why is not the same rule applicable to a nation? What moral right have we to retain the profits that have been gained indeed, but not really earned, in such a warfare?

The revolution which converted us from a debtor to a creditor nation, and which made us at a blow the economic arbiter of the world, is due to the fact that for two and one half years we made these enormous profits. Had we been in the war from the beginning, we also should now have been hovering on the brink of bankruptcy: instead of being able to count the ten billions as assets, our government would probably have been in a position of owing ten times ten billions, as our share of the cost of the war.

And now, after having escaped all these dangers, after having made untold billions of profits out of the contest, after having emerged as the real beneficiary of the war, we have the hardihood to say that our relatively insignificant cash contribution, all of which, incidentally, was expended in this country and went to enrich our people, constitutes a debt which we have the moral right to exact from those who fought by our side and who suffered for the common cause—that is, for our cause—sacrifices incalculably greater than our own!

No—even Mr. Vanderlip is wrong: the Allied debt is not a just debt, if we interpret justice in the only legitimate sense of the term. We advanced the money, indeed, in the form of loan, and legally our position is impregnable. What we actually did, however, was to defray our share of a common burden which, if it were to be adjusted on a truly equitable basis, would make us not the creditor but the debtor of the Allied group. To insist now on our pound of flesh is to take the part of a Shylock, not of a high-minded partner in a joint and common enterprise. The Allied debt is not a just debt; and the sooner that this is realized by our people, wearied by the bickerings of the European nations and still confused by the acerbities of the recent presidential campaign, the better for all concerned.

Even, however, if the Allied debt were a just debt, the economic consequences of insisting upon the payment would be disastrous, not alone to our Allies, but more especially to us. For how can the debt, or the interest on the debt, be paid? Even if the Europeans had the gold with which to discharge the debt, the only result of an influx of coin would be to start us again on that period of currency and credit inflation which would soon create its own nemesis in a gigantic disaster. If the debts cannot be paid in gold, they will have to be paid in goods. How absurd, however, in a period when we are straining every nerve again to set the wheels of industry revolving, to create a situation which will destroy our foreign market, whether for raw materials or for finished products! In a normal situation, imports are paid for by exports and trade is mutually profitable. But where goods are imported as a payment for some past indebtedness, they do not and cannot create any demand for exports in return.

Let us take a leaf out of the experience of Great Britain. The British government thought that it was acting shrewdly in compelling Germany two or three years ago to hand over virtually its entire mercantile marine. This immense increase of tonnage, however, had two unexpected results: freight rates fell so abruptly as to convert the profits of the shipping companies into great losses, as well as to bring the shipbuilding industry to a standstill, with consequent unemployment on a huge scale. Analogous results ensued when France insisted upon the coal payment in kind from Germany. In proportion as the surplus of coal was sold by France to Italy and other countries, it destroyed the British market to such an extent as to produce the coal strike and the prodigious losses which ensued.

Let us look the facts squarely in the face. The Allied indebtedness is primarily that of France, of Italy, and of the other countries that are in an even more parlous condition. For while Great Britain owes us almost a half of the debt, that amount is more than covered by the

sums owing to Great Britain from France, Italy and the other Allies. A general remission of war indebtedness, therefore, will not particularly help Great Britain, except to the extent that a doubtful asset is wiped out to counterbalance a very certain liability.

Whether it may be desirable to accept Mr. Vanderlip's solution and to induce the foreign countries to devote their indebtedness to productive purposes, is a question. For where these countries continue to remain in the slough of despond, there is not much use in asking them to devote to such purposes sums which are not in existence. Let us not try to sugarcoat the pill; let us recognize frankly and spread it broadcast, that for us to insist on the payment of the debt, at all events in any immediate future, is to cast a boomerang which will injure us far more than our debtors. Let us inaugurate a campaign of education to explain to the American people what is the real economic situation. You cannot increase trade by impoverishing your customers; you cannot increase production by destroying your outlets.

It may indeed not be the part of wisdom to cancel the existing indebtedness. It may be more statesmanlike to let the debts remain on the books, and in due time to affix certain conditions to their remission. It may even be desirable to ask our debtors to consent to a certain *quid pro quo* of a political, an economic, or a cultural nature. It would not be difficult to make a catalogue of such possible compensations: free scholarships for American students abroad, free scholarships for foreign students here, a revision of the terms of reparation, a political readjustment in the interests of international amity and good-feeling. But whether we attach conditions to a remission of the debt or simply cancel it outright, let us not commit the folly of cutting off our nose to spite our face. Let us frankly recognize the fact that to insist upon the immediate or even the speedy payment of the debt will constitute an economic blunder of the first magnitude, the unfortunate results of which will be felt in every town and hamlet, in every business and occupation, in every class and rank of our people. Even if the American people prove obdurate to the ethical implications of the problem, let them not blind their eyes to the economic aspect.

III

When we come now to the revenue side of the problem, we find ourselves in the difficult situation of tax readjustment which always follows war. The situation is peculiarly difficult because of the need of a greatly increased permanent revenue. We have become keenly conscious of the pressure of taxation and the controversy has now assumed

the form of contrasting the social and economic effects of taxation with the principle of individual faculty or ability to pay. The old discussion as to the relative merits of direct and indirect taxes has been replaced by the newer debate as to the merits of taxes on wealth compared with taxes on consumption, of taxes on savings compared with taxes on spendings, of taxes on earnings or income as compared with taxes on sales or transactions.

As to this controversy, which must be settled before our fiscal system assumes its permanent form, it may be said that recent years have afforded us considerable enlightenment as to the unintended effects of taxation. Our excess-profits tax had at least three unfortunate results: it was repressive, in that it rendered unavailable large sums which would otherwise have gone towards strengthening and expanding the business; it led to extravagant and wasteful expenditure in the shape of undue advertising, lavish repairs, and over-generous salaries; it engendered more or less unsound changes in business practice by putting a premium on overcapitalization. The analogous British tax led not only to the direct reduction of output, as when the owners of the rubber plantations postponed the tapping of their trees, but it produced an unhealthy traffic in near-bankrupt concerns which had been fairly prosperous before the war because, when several concerns combined, the pre-war records of both together formed the standards which served as the basis of the tax. Our exaggerated surtax rates on incomes undoubtedly operated somewhat to check investment in new enterprises, although if the truth be told it was not so much the high rate as the tax-exemption feature which contributed to this result.

What is often forgotten, however, is that excessive taxes on wealth and industry, while producing their repressive effect on enterprise, indirectly but none the less surely react upon the wider classes of the community whose prosperity is more or less intimately bound up with business activity. An exaggerated tax on industry and commerce which accentuates, even if it does not create, business lethargy and inactivity and which helps to prevent full employment and higher wages, may be as disastrous for the workman as an indirect tax on his expenditure or a direct tax on his wages. There is much reason to believe that our post-war system of taxation has exerted a very perceptible effect on business enterprise and has helped to intensify the prevalent depression, with its aftermath of unemployment and suffering.

But while there is this undoubted danger in exaggerated taxes on wealth, we must not forget that there are equally great, if not greater, dangers in the natural reaction of the business community which seeks to make consumption or expenditure the criterion of tax liability.

Expenditure is an unsatisfactory criterion of taxable capacity. The danger here consists in the neglect of the modern principle of faculty or ability to pay. In the first place, even assuming that all individuals consume the same relative proportion of what they produce, a tax on consumption does not lend itself to a realization of the democratic demand for graduated taxation, unless indeed the tax be limited to an impost on purely luxurious expenditures. Secondly, while some individuals must consume all that they produce, others, under our present economic system, spend only a small part of the wealth that they acquire. To the extent that expenditures deal with necessaries, or even with comforts, taxes on expenditure not only prevent relatively greater burdens on the rich in keeping with their relatively greater capacity as measured by their wealth, but actually impose a relatively greater burden on the poor, thus creating an upside-down progressive system. This has been so universally recognized that every democratic movement in taxation has taken the form of an attempt to reduce taxes on general expenditure.

Finally, from the wider economic point of view, expenditure could serve as a satisfactory criterion of taxable faculty only in case it were desirable, as a general principle, to reduce consumption. In times of emergency, indeed, it may become indispensable to check consumption, in order to have all efforts converge on the purposes of the war itself. But in normal economic life the better way to secure the social surplus which forms the basis of civilization is to increase production rather than to decrease consumption. The increase in wants and in consumption furnishes the stimulus to the augmented production which spells progress.

In this contest, then, between repressive taxes on enterprise and general taxes on expenditure, a proper balance must be struck. The attempt to secure the entire, or well-nigh the entire, revenue from wealth, as we came very near doing during the war, engenders not only grave administrative difficulties but the hazard of a general retardation of economic progress. The endeavor, on the other hand, to lighten the burden of wealth to a degree that it will be actually less, or at all events no greater, than the burden on consumption, will create still more objectionable results. What is far more deplorable, it will breed in great sections of the community the belief that the fundamental principles of equality have been forgotten. If we need, as we undoubtedly do, some revenue from consumption or expenditure, in order to reduce an otherwise extravagant burden on wealth, let us limit the system either to imposts where non-fiscal conditions are paramount, as in the case of the customs tariff, or to taxes on a few commodities

of wide but not necessary consumption, where the administrative difficulties are at a minimum and where the risks of a more or less popular reaction are almost non-existent.

Although our taxes on wealth during the war yielded over 70 per cent, and at one time over 80 per cent, of the entire tax revenue, it became necessary to secure a large return also from a multiplicity of taxes on expenditure, including the so-called nuisance taxes. While, however, every one realizes the necessity of diminishing the excessive post-bellum taxes on wealth, the instinct of the people was undoubtedly correct in opposing the general tax on sales. For this would have unduly depressed the balance so as to impose an exaggerated burden on expenditure. A general sales tax, whether as a part of the permanent revenue system, or even as a means of swinging the contemplated soldiers' bonus, sins at once against the administrative, the economic, and ethical canons of taxation. The new revenue law, with its total anticipated reduction of over 800 millions, has divided the reduction about equally between wealth and expenditure, taking off about 260 millions in the repeal of the excess-profits tax, about 150 millions at the top and the bottom of the income tax, about 270 millions in the repeal of the transportation taxes and about 135 millions in the miscellaneous nuisance taxes. The next tax revision law ought to follow in general the same plan; for, as our needs of revenue diminish, there is still need for the abolition of certain burdensome taxes on expenditure, while at the same time making a further reduction in the taxes on wealth. When in the course of a few years the normal situation arrives, it will be time enough to limit our consumption taxes to the tariff and a few great imposts like those on tobacco, alcohol and gasolene, and to draw the rest of the needed revenue from taxes on wealth and business, which ought not then to be high enough to exert any seriously depressing influences.

While the demand for a tax on expenditure or general sales is limited in this country to some of the industrial and financial interests that seem to attach more importance to particular considerations of putative business progress than to general considerations of a wider economic and social policy, a few students have recently made an endeavor to rejuvenate the long-discarded theory of Mill as to the desirability of exempting savings. The elaborate attempt of Einaudi, a decade ago, met with very little favor at the hands of his compatriots. The more recent effort of Professor Adams, even though seconded by Congressman Mills, is still less promising. This is due largely to the inadequate analysis of the effect of taxation on savings. Since all wealth must be either spent or saved, the effect of taxes on savings might be considered the opposite of the effect of taxes on spending.

It is undoubtedly true that high war taxes on consumption may produce such an enforced economy as to liberate the surplus of increased savings for war purposes. It is difficult, however, to say how much of war economy is compulsory and how much is voluntary and due to patriotic reasons. At all events, it would be hazardous to lay down any general rule as to the normal effects of taxation on savings, because of the disparate elements in the process.

Some people save for one reason, some save for another. Where the saving is for life insurance or for a rainy day, or for the future education of children, a tax which does not exempt such sums would no doubt have an unfortunate effect. But where the saving is for the purpose of mere accumulation, everything depends upon the relative tax burden. This is contingent, however, not alone on the rate of the tax but on the amount of the income. At one end of the economic scale are those whose incomes are so scanty that almost no saving is possible; at the other end are those with such enormous incomes that they cannot well help saving. In the one case, saving is extremely difficult; in the other, largely automatic. A tax which will completely destroy saving in the first class will have practically no effect on the other. It is only when the tax becomes so great as to impair the margin between income and outgo aud thus to prevent savings out of superfluity, that it will affect the capacity to save. Where the capital fund of society is replenished, as in modern times, chiefly by the surplus earnings of business, the rate of tax must be still higher before savings will be perceptibly affected. For while even a moderate tax will undoubtedly reduce business earnings, if we assume that the proceeds of the tax are also spent for productive purposes, as ought to be the case under normal conditions, the result will be a change in the form of capital rather than in the rate of accumulation. It is only when the tax is so high as to check enterprise and to retard production that the surplus will decrease and the growth of the national dividend be checked. In a more general way, the distinction may be declared to be one between productive and unproductive expenditure. In final analysis, the effect of taxation upon savings is to be judged by the possible changes in the creation or in the unproductive consumption of wealth. If taxation is not so excessive as to diminish the rate of production, it makes comparatively little difference to the wealth of the community as a whole whether savings are taxed or not; for the income of one individual is the expenditure of another.

While the general framework of our revenue system may therefore be expected to remain very much as it now exists—that is, composed in major part of taxes on wealth and in much smaller part of taxes on consumption—and while there is no need or prospect of making any

fundamental change involving a transition from the policy of taxing earnings to that of taxing spendings, there still remains a real problem in the existence of such high rates of income surtaxes as we have at present and the continuation of which in normal times it is not easy to defend. There are three ways, however, in which this problem can be attacked.

The first line of attack consists in the abolition of our unfortunate system of tax exemption. It is true, indeed, that the inequality is not so great as appears at first blush to those who overlook the question of incidence. For, so far as new purchasers are concerned, this inequality, like all similar fiscal inequalities, tends to be eliminated through the operation of the principle of capitalization. The purchaser of a tax-exempt security must, in other words, pay so much more for the security that what he gains by an exemption from the annual tax is counterbalanced by his lower rate of return on the investment. The purchaser of tax-free securities is therefore in a truer sense of the term not tax-free.

The objection to tax-exempt securities is, however, nevertheless valid. For, in the first place, this amortization of burden is never complete. Capitalization depends upon the expectation of a regularly recurring normal tax. Where the rate varies, any increase above the normal is not susceptible of amortization, so that freedom from the excess to that extent constitutes a real exemption. Furthermore, the uncertainty of the future often causes a discrepancy in the capitalization, so that the government may not gain as much from an increased price for the bonds when issued as it ultimately loses from the non-receipt of the annual tax. Again, where the tax-exempt securities consist not only of federal but of state and local securities, subject to a variety of different taxes, there is no necessary correlation between tax burden and tax amortization. Above all, the existence of graduated taxation vitiates the conclusions which are applicable only to proportional taxation. With our surtax running up to 65 per cent, it is plainly impossible to predict the rate of tax to which the owner of any particular security would be subject. The utmost that could by any possibility be capitalized would be the 8 per cent normal tax. And even this possibility is modified by the preceding considerations. So that it still remains true that the inequality due to tax exemption is not ironed out by the process of capitalization. There is accordingly ample reason to believe that the abolition of tax exemptions would conduce not only to greater equality but to a substantial increase of revenue. This would not only permit of a reduction in the income tax rate, but would remove a festering sore on our body economic.

Well-nigh a decade ago we pointed out that the supreme court

decisions on this point were based on misapprehension of the economic reasoning underlying Marshall's great decision in the Bank case. Although the matter has for some inscrutable reason not been presented anew to the court, some distinguished lawyers are of the opinion that if the case is ever properly presented it will be recognized that the later decisions rest upon an insecure economic foundation. Even, however, if a reversal or distinction of the earlier decision cannot be secured, the path of constitutional amendment is open and ought in consonance with the recommendation in the President's message to be pursued.

The second method of securing a desirable reduction in the income tax is connected with the taxation of corporations. I have more than once indicated that we, in common with some other countries, started out on an erroneous path in regarding corporations as purely fictitious personalities to be considered from the fiscal point of view primarily as convenient agencies for collecting the tax from the shareholders. We distinguished between the individual income tax and the corporate income tax and levied the latter at a rate roughly calculated to be an equivalent for the normal tax on individuals, permitting shareholders then, for the purpose of the normal rate, to deduct their dividends from their taxable income. In the course of time, this putative equivalence was destroyed; for as the rate of normal personal tax was reduced, the rate of corporate income tax was increased, in order to bring about an equality between corporations and partnerships as well as to compensate for a repeal of the excess-profits tax. There is therefore now not even a pretence of an equivalence between the corporate income and the individual income tax. And even if there were any such pretence, it would manifestly be impossible to secure any real equality between the two. For in order to accomplish this we should have to make an elaborate calculation based on the surtax rate, and should have to know not only how much of the corporate revenue is actually distributed in dividends—which it is possible to ascertain—but also how much other income was received by every shareholder, as well as how many shares were owned by each taxpayer—facts which it is impossible to ascertain.

What is clearly demanded by the situation is to abandon the distinction between individual and corporate taxation and to replace it with one between a personal income tax or income tax proper and a business tax based on net earnings. A business tax would possess the inestimable advantage that it would apply to all businesses, whether corporate or non-corporate, and that it could consequently be levied at so moderate a rate as to constitute no real check to business enterprise. Furthermore, it would apply to all profits, whether dis-

tributed or not; by no longer permitting the deduction of dividends from individual income, it would so augment the yield of the personal income tax as to permit of a considerable reduction in rate.

To this proposition two objections will be raised. The first is that the shareholder suffers a double tax, in that he would pay not only the corporate tax but also the personal income tax. This objection, however, is ill-founded if it is remembered that he would be in no worse position than any one else. We do not call it double taxation, or at all events illegitimate double taxation, for a New Yorker to pay his real estate tax—state as well as local—and again to pay an income tax in which the income from the real estate is included; we do not call it illegitimate double taxation for the same New Yorker to pay his corporate tax, whether on earnings or any other element, and again to pay his income tax on the dividends from these corporations. The reason is that a tax on corporate profits which reduces dividends, like a tax on land which reduces the rent roll, is capitalized into a lower selling value of the principal. The purchaser of a piece of land takes account of the tax when he buys the land; the purchaser of a corporate share will pay for it a price which reflects the net yield and which takes account of the tax. To subject the corporation to a tax does not impose any burden upon the individual who purchases stock subsequent to the original imposition of the tax.

The other objection is that the individual business or the partnership is put at a disadvantage as compared with the corporation, in that the member of a partnership has to pay not only the flat business tax but also the graduated personal income tax. This objection, however, is also in part at least invalid. We must not compare an impersonal tax on the business with a personal tax on the individual. A flat tax on business profits affects all businesses alike—corporate or non-corporate. The fact that the individual as such is subject to additional personal taxes does not alter the situation. For the equality between personal and impersonal taxation, which it is impossible to bring about at first directly, will tend to be effected ultimately. It is true that in the case of a corporation, the shareholder will pay his personal tax only on the dividends, while the partner will pay on the entire earnings. But the attempt to create an equality by putting a tax on the undistributed corporate earnings is both illusory and unnecessary. It is illusory because a flat rate on undistributed earnings of the entity called the corporation cannot possibly be made equivalent to a graduated tax on the individual recipient of the earnings. How can a 15 per cent tax on undistributed earnings, for instance, be equilibrated with a tax which in the case of the individual recipient of the earnings may vary from 8 per cent to 65

per cent, according to the amount of his income? Moreover, a tax on undistributed earnings will not alone fail to produce equality, but will be apt to engender unsound business practices in forcing the perhaps premature distribution of earnings.

The attempt to create equality is also in great part unnecessary. For the government will ultimately secure its rightful share of the undistributed earnings. One of three things must happen: first, the surplus accumulated in a good year will be utilized to reduce the deficit in a bad year, and, especially with a tax system which employs the method of averages over a number of years, will operate finally to give the government its due. Second, the accumulation of a surplus beyond a certain point will be apt to be prevented by the pressure of the stockholders to receive dividends, so that if the rate of taxation remains fairly constant there will be little advantage in delay. Third, with every accumulation of surplus the stock will become more valuable, so that when it is sold the government will secure its share in the taxation either of capital profits or of periodical income. This assumes, of course, that realized capital profits are to be included in the concept of income.

The only real hazard in the proposition is that individuals will attempt to incorporate themselves and, by refraining from a distribution of the corporate earnings, evade the graduated tax. But this danger can be avoided by treating the stockholders of such dummy corporations precisely like the members of a partnership and subjecting them also to personal taxes on the entire earnings. If this seems to be attended with insuperable practical difficulties, a compromise solution might be reached by making the corporate business taxable at a somewhat higher rate than the unincorporated business—a proposition which can be defended on other grounds as well.

Even this compromise, however, will not avail to obscure the desirable distinction between an impersonal tax on the business and a personal tax on the income of the individual. The most logical plan is that followed by France, whose new system of income taxation is based upon no less than five impersonal taxes or taxes upon the sources of income: ownership of land, agricultural enterprise, business, investments, and professions; superimposed upon which there is a general graduated personal income tax. Such a detailed system would be for many reasons both unnecessary and impracticable for us; but we should at least accept the fundamental distinction between an impersonal business tax and a personal income tax.

There remains the third method of reducing the income surtaxes, even if we desire to retain the same total and relative revenue from

wealth as compared with that from expenditure. This consists in an increase in the inheritance tax.

We do not indeed share the opinions of those who, regarding the inheritance tax simply as a capitalized income tax, yet deem it preferable because of the less repressive effects on saving. Mr. Carnegie, for instance, believed that an inheritance tax exerts no influence on savings, and even Profesor Cannan holds that "death duties discourage accumulation somewhat less than annual taxes." Professor Pigou shares this conclusion not only because "the stimulus to accumulation consists in the hope of the distinction afforded by dying very rich," but also because, inasmuch as future taxes are like all future events discounted, the delay in the levy will have "a smaller restrictive influence upon the quantity of waiting supplied" by the investors. But this consideration which leads to the superiority of postponed over immediate taxes is offset, as Sir Josiah Stamp has recently pointed out, by the fact that most people will be more apt "to curtail expenditure to meet an annual income tax and to keep on saving and thus in the long run add more to capital than would be the case under the death duty régime."[4]

From the point of view of savings, there is accordingly but little to choose between the two methods. There are, however, two sets of arguments that make for an increased revenue from the inheritance tax. The first is that the discrepancy in both the rate and the yield of the inheritance tax, as compared with the income tax, is at present too great. In Great Britain the maximum rates are about 40 per cent and 60 per cent respectively; with us, they are 25 per cent and 73 per cent respectively. The discrepancy in the yield is still greater: 150 to 200 millions from the inheritance tax, as compared with about 800 millions from the personal income tax. If it be objected that these figures take no account of the additional state taxes on inheritance, we may retort that they also take no account of the additional state taxes on income and on property. Adding state to federal taxes would make the discrepancy still greater.

The other set of arguments that make for an increased revenue from inheritance taxes are, first, the administrative simplicity and the avoidance of so many of the complications connected with the attempt to ascertain income. Secondly, in the United States, a further argument is found in the fact that a federal inheritance tax of slightly more generous proportions than at present composed, as is the case in so many foreign countries, of both an estate tax and a tax on shares, would also render possible the disappearance of the serious evil of double taxation now so common with us. We can therefore not agree with the Secretary of the Treasury when he puts a suggested

[4]Sir Josiah Stamp, *Principles of Taxation* (1921), p. 154.

reduction of the federal estate tax on a par with that of the income tax. A rate of tax considerably lower than the maximum 40 per cent of Great Britain or the 80 per cent of France would not only permit each state in the Union to receive more than it is now securing from its own independently levied inheritance tax, but would yield such an abundant surplus to the federal government as to ensure a substantial reduction in the rate of the income tax.

The fiscal system of the future may therefore already be visualized in its main outlines. Government expenditures before the war were, exclusive of postal expenditures, somewhat less than three quarters of a billion. If we allow for the change in the value of money, and for a corresponding leveling up of government salaries, which has by no means as yet been attained, our normal expenditures, exclusive of postal and debt charges, should not be more than one and one-half billions. This assumes, indeed, that the mad race of naval competition will have been checked; and for this assumption we now have well-grounded hopes. The allotment for interest charge and a liberal amortization of the war debt, without counting on the repayment of the debt from the Allies, would be about one and a quarter billions. Allowing for contingencies, we thus have a total annual outlay of well under three billions.

How do we stand now on the revenue side? From a revised tariff which already now yields three hundred and fifty millions we may well expect five hundred millions. From three individual sources, namely tobacco, non-beverage alcohol, and automobiles or gasoline, we can easily secure another half billion, as in fact we are already now doing. With a slight increase of stamp taxes and the suggested increase in the rates of the inheritance tax, it will be relatively simple to secure another half billion. This leaves less than one and one-half billions to be derived from profits and income taxes. The general business tax that has been suggested should under normal circumstances provide about three quarters of a billion, leaving approximately the same amount to come from the income tax. With a more generalized conception of income, so as to include dividends, and with a change in the awkward situation which permits a complete deduction for capital losses, while making incomplete provision for capital gains, we can look forward to a personal income tax with considerably reduced surtax rates and moderately reduced normal rates. And if it should be found expedient slightly to retard the tempo of debt payment in order to spread over a somewhat longer period the gigantic burden of the war, it would be possible still further to lower both the surtax and the normal rates of the income tax or to go somewhat slower in the suggested increase of the inheritance tax.

Such a prospect is a reasonably cheerful one. It implies a fiscal system which will exert little repressive influence on enterprise, which will put no burden on the consumption of necessaries or of comforts, which will render unnecessary a resort to the sales or the spendings tax, which will turn a deaf ear to those who in advocating a remission of the tax on savings are in reality working toward a remission of the tax on wealth, and which will finally respond to the demands of democratic justice without incurring the hazards of administrative inefficiency. With a stoppage of the mad race for armaments, with a more successful emphasis on budgetary economy, and with a fuller recognition of the fundamental principles involved, we may look forward with hopeful anticipation to a sound and sensible fiscal system.

EDWIN R. A. SELIGMAN.

Columbia University.

DISCUSSION.

JOHN E. ROVENSKY.—Professor Seligman's excellent paper is divided into three parts: the first is introductory in character; the second deals with our present debt situation and the expenditure side of our balance sheet; the third deals with our revenue problem.

I shall confine myself largely to the second part, but, before proceeding, I cannot pass Professor Seligman's conclusions on branch banking without voicing my disagreement. He states that "the reason for........credit inflation when nearing the crest of a boom period is to be sought largely in a continuance of the competitive conditions among our thirty thousand American banks" and recommends branch banking which he believes would convert "the multiplicity of competitive institutions........into a chain of coöperative banks working together." It seems to me that Professor Seligman overlooks the fact that inflation increases only while a majority of the captains of industry and finance are of the opinion that commodity prices are likely to advance, i. e., that really dangerous inflation does not exist. As soon as they begin to recognize the existence of dangerous inflation and to doubt the stability of commodity price levels the crisis becomes imminent. If this is true, then I fail to see how fewer banking institutions would remedy the matter. So long as the managers of the fewer banks proposed by Professor Seligman believed that commodity prices are on a safe basis and that dangerous inflation does not exist, they would continue to extend credit within the limits that they deemed safe just as banks do at present. I believe that the history of banking in countries having branch banking systems fully bears out this conclusion.

Furthermore, I don't believe that competition caused banks to grant excessive credit during the period of advancing prices. The comparatively small losses suffered by commercial banking institutions are evidence of that. Individual institutions are careful not to jeopardize their capital by unwise